AIXTRON SE

Analyst Earnings Conference Call

Q1/2019 Annual Results
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Prepared Remarks

Executive Board

Dr. Bernd Schulte, President

Dr. Felix Grawert, President

Finance & Administration

Charles Russell

Conference Call Participants

Janardan Menon – Liberum

Uwe Schupp – Deutsche Bank

Charlotte Friedrichs – Berenberg

Veysel Taze – Bankhaus Lampe

Malte Schaumann – Warburg Research

Andrew Gardiner – Barclays

The spoken word applies

Slide 1, 2 – Operator & Forward-Looking Statements

Operator

Good morning, ladies and gentlemen, and welcome to AIXTRON's Q1/2019 results conference call. Please note that today's call is being recorded. Let me now hand you over to Mr. Guido Pickert, VP of IR & Corporate Communications at AIXTRON, for opening remarks and introductions.

Guido Pickert

Investor Relations & Corporate Communications

Thank you, operator. Let me start by welcome you all to AIXTRON's presentation of our Q1 2019 results. I'd like to welcome our Executive Board represented by Dr. Felix Grawert and Dr. Bernd Schulte, as well as our VP of Finance and Administration, Charles Russell.

As the operator indicated, this call is being recorded by AIXTRON and is considered copyright material. As such, it cannot be recorded or rebroadcasted without expressed permission. Your participation in this call implies your consent to this recording.

As with previous results conference calls, I trust that all participants have our results presentation slides, page 2 of which contains the usual Safe Harbor statements. I would like to point out that this applies throughout the conference call. You may also wish to have a look at our latest IR Master Presentation, which includes additional information on AIXTRON's market and its technology and is available on our website as well.

This call is not being immediately presented via webcast or any other medium. However, we will place an audio file of the recording or a transcript on our website at some point after the call.

I would now like to hand you over to Dr. Bernd Schulte for opening remarks. Bernd?

Slide 3 – Q1/2019 Highlights & Operational Performance

Dr. Bernd Schulte

Executive Board

Many thanks, Guido, and a warm welcome from my side as well. As usual, I will give you an overview of AIXTRON's key developments in Q1 2019 before handing over to Charles Russell, who will go through the financials in more detail. This will then be followed by Felix Grawert for an update of some of our important development projects and a wrap-up.

Q1 2019 beat our expectations for margins and earnings with a gross margin of 39% and an EBIT margin of 14%. A strong U.S. dollar and the lower product costs as a result of cost-saving measures have supported these figures.

Orders at EUR 54 million have been in line with that what we said during our full year 2019 conference call as they reflect the expected reluctance of customers to invest in the expansions of their production capacities before next-generation end product launches have been cleared. Taking this into account, we confirm our full year guidance with total orders to be received in the range between EUR 220 million and EUR 260 million.

In the short- to mid-term, we expect a growing demand for lasers due to the increasing demand from 3D sensing, security infrastructure or optical data transmission. In the longer-term, we also see the increasing use of LEDs, microLEDs and special LEDs in display and other applications. In addition, we expect an increased use of gallium nitride or silicon carbide-based devices for wireless communication and efficient energy management in automobiles, consumer electronics and mobile devices.

With that, let me now hand you over to Charles for a more detailed overview of the Q1 2019 financials. Charles?

Slides 4-6 – Q1/2019 P&L, Cash Flow, Balance Sheet

Charles Russell

Finance and Administration

Thanks, Bernd, and hello to everyone. Starting on Slide 4, our income statement. Total revenues for Q1 2019 were EUR 69 million compared with EUR 62 million in the same quarter of the previous year. Gross margin was 39% in the quarter compared to 43% in Q1 of 2018. This expected reduction in margin was caused by an increased share of sales for LED applications.

The continuing strong dollar had a beneficial effect during the quarter, at least compared with our guidance, which is based on $1.20 to the euro. Approximately 70% of our sales are in U.S. dollars. Steadily reducing product costs have also had a sustainable beneficial effect on our margins. Specifically, we have achieved some significant product cost reductions by sourcing components from different suppliers and also reduced warranty expense by improvements in reliability.

Operating expenses in the quarter were EUR 17 million, slightly below previous quarters because of lower project-related expenses.

Selling expenses of EUR 2 million in Q1 2019 were in line with last year on a quarterly basis. Both G&A expense and R&D costs were less than previous quarters because of lower project-related expenses. G&A was EUR 4 million in Q1 and R&D EUR 13 million in the same period. The R&D expenses for the OLED activities in Q1 were just over EUR 4 million. R&D costs fluctuate over time depending on the different activities being performed. This is a normal feature of R&D and is not a cost-cutting exercise.

Overall, EBIT for Q1 was EUR 9.7 million and net income EUR 8.5 million.

Turning to the balance sheet on the next slide. Inventories of EUR 80 million include some prototype power electronic systems, some of which are at customer sites as well as safety stocking for Brexit. PP&E includes the capitalization of EUR 3.9 million of leased assets under IFRS 16. Payables have reduced because we paid suppliers for the increased inventories. And customer deposits are lower, reflecting the order intake in the quarter.

Moving to slide 6, which shows our cash flow statement. The CapEx of EUR 5.6 million includes EUR 3.9 million of leased assets. The changes in working capital that I have already described meant that the free cash flow was minus EUR 18 million in Q1. And we ended the quarter with EUR 248 million in cash.

With that, let me hand you over to Felix.

Slide 7, 8 – Summary and Guidance

Dr. Felix Grawert

Executive Board

Thank you, Charles. Before getting to our outlook, let me quickly give you an update on where we stand in our OLED qualification process and in our development process of the new silicon carbide power electronics tool.

We completed the installation of our Gen2 pilot production OLED tool within our customer's facilities as we told you in February. Currently, the tool is being put into operation jointly by the customer and our APEVA engineers. This represents another step forward on the way to the qualification of the OVPD technology. In the coming months, the joint operation of the system shall confirm the performance of the technology and the resulting data will be the base for the customer's decision to order production size chamber during 2019.

In power electronics, we have installed multiple beta systems of our new fully automated, high-throughput silicon carbide tool at customers in order to perform beta test and to qualify our tool for device manufacturing. At the same time, we are seeing strong interest from all relevant power players in the market for our technology. This makes us very confident that we are on the right path to address major market opportunities in power electronics lying ahead of us.

Now looking at slide 8, we can confirm our 2019 guidance that we have issued in February. We expect to receive total orders in the range between EUR 220 million and EUR 260 million, which means that we need to report additional orders of EUR 166 million to EUR 206 million on top of what we reported in Q1 during the remaining three quarters of 2019. This range considers both the geopolitical and the customer-specific uncertainties as well as the still unclear magnitude of a possible order in the OLED segment.

Revenues are expected to be between EUR 260 million and EUR 290 million. Gross margin and EBIT margin are expected to be between 35% to 40% and 8% to 13%, respectively. Free cash flow for 2019 is expected to be between EUR 15 million and EUR 25 million. We are fully on track to reach the guided levels in all dimensions, also in terms of free cash flow despite the negative free cash flow value reported in Q1. Please note that these estimates fully include the result in CapEx of APEVA and are based on our budget rate of US$1.20 per EUR.

With that, I'll pass it back to Guido before we take questions.

Guido Pickert

Investor Relations & Corporate Communications

Thank you, Bernd, Felix and Charles. Operator, we will now take the questions, please.

Question-and-Answer Session

Operator

[Operator Instructions] The first question comes from Janardan Menon from Liberum.

Janardan Menon

Yes. Hi, good afternoon. Thank you for taking my question. I have two questions. One is on your order trend and what you're seeing in the market. Today, AMS reported results in the morning and they sounded a lot more upbeat about how the adoption of 3D sensing is going on in the Android side. And they're seeing an increasing number of models coming out, which have 3D sensing both on the front and the back of the phone.

I was just wondering, given that commentary, how would you compare what you're seeing in the market today versus three months ago, when you gave the guidance for the full year of EUR 220 million to EUR 260 million of orders? Are you feeling – I mean, is it a slightly better environment? Or would you say that it's pretty much the same and you have not seen any of the sort of improvement that companies like AMS are talking about reflect in your discussions with customers as yet?

And my second question is on silicon carbide. So, you said you're in qualification at a number of customers and that there's interest in the equipment from them. When can we expect the qualification to be completed? And therefore, when can we expect some orders to be placed by these customers for your new machine?

And lastly, in your order guidance of EUR 220 million to EUR 260 million, have you factored in any orders from silicon carbide at all? And if they do come in, what would be the effect on your order book?

Dr. Bernd Schulte

Thank you, Janardan, for your questions. Let me try to answer your first question. The current order level and activities and quotations at the moment are quite diversified in applications and regions. And this is why it's not fully clear yet, how the second half develops. And we always mentioned that the earliest we see a potential comeback of orders for the 3D sensing market would be in the second half. So, with the current view we have on these quite diversified order patterns, as I said, in applications and regions, it's difficult to say how the second half will develop in terms of orders, i.e. to say whether we are more at the lower or the higher end of our guidance. So it's a bit early.

Janardan Menon

Okay. But you have not seen any increase in inquiries or anything like that coming through over the last three months from the 3D sensing side?

Dr. Bernd Schulte

No, it's still too diversified to see a real movement.

Janardan Menon

Understood. On the silicon carbide?

Dr. Felix Grawert

Yes. On the silicon carbide, I think you had three questions, right? The first one I understood is when the qualification will complete. We do expect the first customers to complete their qualification throughout 2019. And that leads to when we can expect follow-on orders from the customers who have a tool currently in the qualification process. I expect that we will see follow-on orders towards Q4 2019, Q1 2020, sometime in the upcoming winter. And yes, for sure, we do have a number of silicon carbide orders already included in our guidance.

Janardan Menon

Understood. Thank you very much.

Uwe Schupp

Yes. Good afternoon, gentlemen. Two questions, please. Let me rephrase the first question from Janardan. Basically, looking at your Q1 orders and where your guidance for the year stands, obviously implies that you are guiding for an improvement in coming quarters just in order to arrive at the low end. Is there any indication that would support that? Or is it basically purely based on hope? And then secondly, Charles, just on the higher inventory that you alluded to, I think inventories were up 70% or if not, more year-over-year. How much of that is Brexit-related? And what other effects may be included here that we may not be noticing? Thank you.

Dr. Bernd Schulte

Thank you, Mr. Schupp, for the question. Speaking about the order intake, first of all, if you multiply our order intake of the first quarter times 4, you're very close to our lower end of the guidance. So, it means you are right. We need an increase to achieve the upper end or somewhere in between both ends of the guidance. And, as we mentioned in the previous call and as I mentioned before, we still see the potential of an increase in the second half. In particular, 3D sensing basically has digested the current capacity and needs further increase in output and preparation, for the growth in the year 2020 and so on. As I said, it's very difficult to be more precise right now. We're seeing a good activity in quotations in the moment. But the applications, in particular also the regions, are too diversified in order to see really a clear pattern yet.

Uwe Schupp

Thank you.

Charles Russell

And on the questions about inventory, we have a sort of mid-single-digit million figure of inventory related to Brexit. We have a little bit more than that related to prototypes. And our inventory is there to be built against customer orders. We're not building based on speculation, if that was the aim of your question.

Dr. Bernd Schulte

And also keep in mind, if you look in our guidance and what the Q1 revenue has been, there's clearly a requirement of an increase in revenues for the coming quarters. And you heard from Felix very clear, his confidence in achieving our guidance, does mean that our production needs to prepare this output, which will end in an increased work in progress. And also we're doing increased activities with customers on the qualification of our power electronic tools, which also means we have tools at customers which are still in our reported WIP.

Uwe Schupp

That’s very clear. Thank you.

Charlotte Friedrichs

Hello. Thank you for taking my questions. The first one would be around your expectations for LED orders. You had a larger share of revenues coming from LED in the first quarter. And my question would be what your expectations are for Q2, if there's much more to come or if we're pretty much done with these larger orders?

Then the second question would be around order intake in the first quarter, if you can tell us may be a little bit what the split here is between end markets.

And then finally, on the cost side for 2019, do you expect any meaningful changes in your OpEx? Or is Q1 pretty much run rate now? Thank you.

Dr. Bernd Schulte

Yes, let me talk about our expectations in the LED sector. I think I mentioned in our annual 2018 call that for 2019, we do not expect significant orders in the field of red-orange-yellow LEDs. This is because we have received significant orders in 2018. With shipments you're seeing in first quarter and second quarter, if you look in the application split of our revenue, you'll probably see the strong portion of the LED part. And with that capacity getting installed right now, we do not see a continuation of the capacity requirement in the short- to medium-term. So, the view is pretty much unchanged to what we said two months ago, when we presented our full year figures. So, for 2019, we do not expect significant orders from that application.

The split in orders, you mentioned orders of Q1, was fairly evenly split between laser device application as well as power electronics and solar cell. So this was basically the split, not really dominated by one of the applications. It really echoes what I mentioned about also the short-term outlook for orders, it's pretty much diversified.

Charles Russell

In terms of the OpEx, I think I mentioned that the OpEx fluctuated and it was quite low for some of the spend in Q1. So we do expect it to be a little bit higher in the rest of the year.

Charlotte Friedrichs

Okay. Thank you.

Veysel Taze

Yes, hi. Several questions left. One would be regarding your power business. You mentioned some Beta tools. Can you just give a color, if you go back like six months, have you added new customers in the space? And can you give a color around SiC and Gallium Nitride, how these both areas were in Q1? And how do you expect them to shape up throughout 2019?

Dr. Felix Grawert

Yes, thank you. So let me first comment on the silicon carbide and later on the gallium nitride. So silicon carbide, as mentioned before, we are in the process of bringing out our automated high-throughput system, that is the beta tools are all for the high-throughput system. We have placed the tool at multiple customers. It is existing customers, which we have been serving in the past, but it's also additional new customers. This shows that we've been able to expand our customer base. And now all these customers are all running these tool qualification programs, as mentioned before, throughout the year 2019. And we see broad interest from even a further group of customers in the market. So, of course, it is our target to even further broaden our customer base.

Now let me just comment on gallium nitride, the second part of your question. As you know, and as we have mentioned previously, we have a strong customer base on the gallium nitride power electronics. Most recently, we have been seeing increased activity and increased demand from customers in the gallium nitride RF area, especially preparing for the 5G build up. Also here, we have seen a number of orders that led to broaden the customer base. We expect this trend to continue throughout the year 2019, and also throughout 2020. However, of course, as I was mentioning for gallium nitride, it is an increase is coming from a relatively small base in terms of number of systems sold and in terms of revenue.

Veysel Taze

Okay. And then on your order entry level in Q1, would you say that the EUR 54 million, you were surprised that it was above EUR 50 million? So were there some positive impacts or surprises? And would you say Q1 order entry marks the low point for the year and we should see gradual recovery each quarter, so to say, for the rest of the year?

Dr. Bernd Schulte

Well, as I mentioned, it's really quite diversified in applications and that's what we're seeing ongoing also currently. So it's not like that one application dominates the demand for tools right now. And I wouldn't say that there was big surprises in order intake in Q1. It always also depends on when we can book orders and, for specific customers in areas where you need export licenses, when you get clearance by the authorities. And that may shift orders from one quarter to the next which sometimes can be a surprise simply in the timing because with authorities involved it's not always as simple to forecast when your application gets processed and cleared. But with respect to customers and markets, there were no surprises. And as I mentioned, the development in the second half is still quite difficult because we do not see, let's say, one application really pushing forward to a significant order trend, as we stand here today.

Veysel Taze

Okay. So, on seasonality, still do you think there will be Q-on-Q improvements? Or what is your assumption there? So any color on the seasonality would be really very appreciated.

Dr. Bernd Schulte

Well, I think in our business, there's no seasonality. It's really driven by the investment into ramp-ups of certain applications. And I think Janardan mentioned it, I can only read what you also read regarding the positive outlook of some players in the 3D sensing market. And we are convinced that eventually will also turn into orders for new equipment. When that will be strongly depends on the demand, on the yield, on the output requirements, et cetera. So that's a very complex formula, which is very difficult for us right now to answer. But in general, that's what we keep saying, we are convinced that in the 3D sensing market the demand is intact. But I cannot tell you whether this will be in Q3, Q4, Q1 or Q2. That's very hard to say. It depends on many factors.

Veysel Taze

Fair enough. And just one final, if I may. Charles, you mentioned some comments regarding the R&D costs. It would be helpful if you could just repeat them.

Charles Russell

So, it's just that R&D costs fluctuate over time and that the low level of R&D spend in Q1 is not indicative of a cost-cutting program.

Dr. Felix Grawert

So let me add to this, the R&D cost is essentially composed of two elements, right? The one is personnel costs, which are kind of flat because the salaries of the people that are on board are paid out every month. However, the material cost level, which also goes through there, it depends on how prototypes are being built and how material spend is going through. And that is variable, which is fluctuating. And it just happened by chance that in the third quarter, the number was a little bit lower because less material was consumed.

Veysel Taze

Thank you very much, gentlemen.

Malte Schaumann

Good afternoon, gentlemen. The first one is on the gross margin. The gross is close to 39% on the first quarter despite a relatively high share of the LED tools. Unless you're seeing maybe U.S. dollar above $1.15, which does not seem to be on the cards, would it then be fair to assume that your gross margin might develop towards the upper end within your given guidance range?

Dr. Felix Grawert

Our guidance, also the gross margin estimates, are based on $1.20 per Euro. If you want to determine what effect the U.S. dollar can have, you can calculate this by assuming that about 70% of our revenues is based on U.S. dollar and you can make your own assumptions, as you just did, which potential U.S. dollar rate is likely. And very clear, as said before, we confirm our guidance in the percentage range based on the U.S. dollar rate that we have given. The rest, is just simple calculations.

Malte Schaumann

Yes, okay. Then on OLED, has the qualification process been more or less pretty much on track? Were there substantial kind of further technical hurdles upcoming that might have delayed something? Or how do you see the general qualification progressing?

Dr. Felix Grawert

Yes, the qualification progress is on track and the tool has been installed. What's now happening is a number of functional tests of the tool. It's a very complex tool with a huge set of functionalities. Step by step all the different functions are being tested and the elements and building blocks of the tool are being put into operation. And when that is completed, then complete OLED stacks will be produced by the customer. Based on this, the customer, from running the tool and producing these R&D-type OLEDs, will get measurement data and make his decision. Thus, within the complex qualification process, things are on track.

Malte Schaumann

Okay. Are you willing to provide a time frame when the R&D OLED stacks should be ready to be produced?

Dr. Felix Grawert

No, we wouldn't comment about details of that. But everything happens throughout 2019.

Malte Schaumann

Yes, sure. Okay. Good, thanks.

Andrew Gardiner

Good afternoon. Thanks for taking the question. I had another one on gross margin. To the prior question, the mix, at least relative to last year, was weaker in the first quarter. And you've already stated how you expect LED to remain at a relatively high level in the second quarter. Can you sort of give us an idea of how you're planning for mix to progress through the year? Is first quarter the weakest level of product mix and therefore gross margin that we can expect?

Dr. Bernd Schulte

Yes, Andrew, I think for second quarter, it's fair to assume it will be in a similar range because also the product mix might be quite similar to the first quarter because we mentioned that the second quarter will again include a number of LED tools. Now, what's not clear is what will be the dollar month-to-month. But I leave it to your own judgment what the dollar in the short term may do. In the second half, the mix of applications and products we will ship in the second half is not fully clear because that's pretty much defined by orders we're taking now, particularly for the second quarter. So, I personally do not expect a significant reduction in margins for Q3, and Q4 is depending, of course, on the mix of orders.

Andrew Gardiner

Okay. Understood. And perhaps one for Charles again on gross margin point, you highlighted some of the savings you had in the first quarter around product cost and warranty cost. I presume those are sustainable. But can you help sort of quantify that? Is there – was that a material element of gross margin in the first quarter that we can expect to continue? Thank you.

Charles Russell

What we've done is over the last 12 months or so, we've steadily reduced the product costs and we expect that to be sustainable into the future. And we have an activity, which takes place here in Germany to continually reduce those costs. And that's what we expect to do in the future.

Dr. Bernd Schulte

To be clear, of course, the larger portion of the increase in gross margin came from the dollar. I think it would be unfair to say that these were mainly driven by cost reduction measures. As Charles said, they are continuous improvement measures. And they add a few tenths of a percent per month or quarter and add up over time, over a year to a range of 1% or maybe slightly more than that.

Andrew Gardiner

Thanks very much. That's helpful.

Guido Pickert

Thank you very much, everybody, who was listening. With that, we are closing our Q1 2019 earnings call. As I said, thank you for joining, and bye-bye. See you and talk to you next time.